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J. R. Gould

B. S. Yamey

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J. R. Gould† and B. S. Yamey*

In a recent article Professor Bork presents a vigorous and interesting defence of vertical price fixing or resale price maintenance (hereinafter referred to as r.p.m.).[1] He argues that where it is not practiced either in response to resellers' cartels or as part of a manufacturers' cartel, it must be practised in the interests of greater efficiency, larger output and improved satisfaction of consumer wants. Excluding the cases of r.p.m. practised in response to resellers' cartels or as part of manufacturers' collusion, Bork says of r.p.m., *inter alia,* that "the economic analysis of such restraints . . . indicates that they . . . will never be instituted with either the intent or the effect of restricting output."[2] "In the case of an individual manufacturer's imposition of restraints upon competition among its resellers . . . the manufacturer's motive can never be restriction of output. An alternative explanation of the manufacturer's behavior is necessary, and the only satisfactory alternative hypothesis is that the manufacturer believes the restraint will increase its net revenue by increasing distributive efficiency. This is not to say that the elimination of competition among resellers may not have some tendency to affect efficiency adversely. . . . But any such adverse tendency must be outweighed by a tendency to create efficiency. Otherwise, the manufacturer would not employ the restraint."[3] Bork, it should be noted, intends his conclusions to apply regardless of the extent of monopoly power of the manufacturer.

The novelty of Bork's approach lies not in its recognition that it is conceivable that in some circumstances the use of r.p.m. may increase the manufacturer's sales and be of advantage to consumers, but in its attempted demonstration that, in the absence of cartels, the use of r.p.m. cannot fail to have this effect if adopted voluntarily and independently by a manufacturer, that is, that it cannot have the intent or effect of reducing output. Many who hold the view that r.p.m. in general is against the interest of consumers nevertheless concede that there may well be particular cases and special circumstances where the prac-

† Professor of Economics, London School of Economics and Political Science.
* Professor of Economics, London School of Economics and Political Science.

1. Bork, *The Rule of Reason and the Per Se Concept: Price and Market Division II,* 75 YALE L.J. 373 (1966) [hereinafter cited as Bork].
2. Bork at 475 n.207.
3. *Id.* at 403.

tice may promote the interest of consumers, and therefore that in principle a case-by-case approach by the monopoly control authorities may be warranted. The importance of Bork's thesis is that, in a whole class of cases, the authority would only have to establish the absence of cartel-like behavior before it could give its approval.

I.

In this section four analytically distinct counter-examples are presented to show that r.p.m. can be practised so as to restrict output and raise prices, thereby refuting Bork's major contention. The first counter-example shows that output can be reduced even where r.p.m. raises the efficiency of distribution. The second shows that r.p.m. may have the effect of reducing output even where the intention is to increase it. The third shows that a monopolist manufacturer can use r.p.m. to preserve or strengthen his monopoly position and so restrict output. The fourth shows that each of a non-colluding group of manufacturers can use r.p.m. to reduce competition *inter se* and so restrict output. Of the four counter-examples, the first two do not, while the last two do, involve an increase in the extent of monopoly in manufacturing. None of the four depends on the presence of a cartel.

For the first counter-example suppose a manufacturer is contemplating two alternative sales strategies to secure dealer support: the first is an expensive *advertising campaign directed to retailers through trade journals;* the second is to institute r.p.m. to raise retail margins above the competitive level. Assume that each strategy has an equal effect on the consumer demand curve, but no effect on the degree of monopoly power enjoyed by the manufacturer. If we analyse this within the framework of the standard theory of the firm the cost of the advertising campaign would be a fixed cost (*i.e.*, independent of output) but the increment in retail margin would be a direct addition to marginal costs.[4] Thus the marginal cost curve with r.p.m. would be higher than that with advertising and would cut the marginal revenue curve (common to both strategies by hypothesis) at a smaller output. It is quite possible that r.p.m. is the more profitable strategy, the more "efficient" from the manufacturer's point of view. Nevertheless, the result is a smaller output and a higher price to consumers.

We are not here concerned to discuss how welfare is affected in these

4. Alternatively—and with the same results—the increment in retail margin could be treated as a reduction in the manufacturer's marginal revenues.

circumstances. The point of the counter-example is that it destroys the cornerstone of Bork's thesis—namely, that if r.p.m. is not introduced to increase monopoly power it must be done because it improves distributive efficiency and *therefore* benefits consumers through larger output and lower prices.[5] More generally, we cannot predict the effects of an increase in efficiency in distribution (from the manufacturer's point of view) without careful analysis of the effect on both costs and revenues.[6]

The second counter-example is the possibility that each of a group of competing manufacturers may adopt r.p.m. in a competitive attempt to secure the support for his brands from those resellers who are in favour of r.p.m. and prefer large unit gross margins to smaller. All that is necessary here is that at the time such resellers should constitute a large enough segment of the market, and that they individually have enough power to influence consumer purchasers towards the favoured brands. If each or most of the manufacturers adopted r.p.m. for this reason, the competitive sales-increasing effect would be neutralised; and, other things being equal, total sales would be smaller. The *intent* behind the adoption of r.p.m. is to increase sales; the *effect*, however, is to reduce sales by raising distributors' margins and consumer prices. Nevertheless, it may not be in the interests of any one manufacturer to put the process in reverse and disencumber the industry of its competitively imposed burden of higher reseller margins and the restriction of reseller competition.

It should be noted that this counter-example does not depend on reseller collusion or a reseller cartel. It requires no more than that sufficient effective sales support can be bought by a manufacturer through the medium of the introduction of r.p.m. and through the raising of resellers' gross margins. It requires no initiative or pressure on the part of individual resellers or concerted groups or resellers, but only an appropriate pattern of response to inducements. (Resellers can also, of course, make known their preference for r.p.m. without in any way acting as a cartel.) The competitive introduction of r.p.m. is a clear possibility where manufacturers do not agree to eschew this particular

5. Bork at 391.

6. R.p.m. may affect the demand curve; a conceivable example would be that of an article which, via r.p.m., is placed in the class of prestige goods, a process which may have the effect of pushing outwards the upper part of the consumers' demand curve and making it less price elastic. This would allow the possibility that the marginal revenue curves with and without r.p.m. intersected. In turn this permits the possibility that the profitable institution of r.p.m. leads to a lower output.

method of sales promotion (which like some other methods is cost-raising but unsuccessful if generally adopted).[7]

The third counter-example refers to a monopolist manufacturer. It may be in his interests to introduce r.p.m. in order to control the structure of the distributive trade. Resale price maintenance may inhibit or delay the development of large-scale reseller firms. Such firms may be in a strong position to secure price concessions from the manufacturer, which he would not need to give to smaller resellers; and they may be able to introduce their own private brands in competition with his brands. The manufacturer, therefore, would have an interest in avoiding these effects by introducing r.p.m. and helping to preserve the status quo in distribution.[8] To the extent that this strategy was successful, it would serve to reduce output and raise prices.[9]

The final counter-example relates to the effect r.p.m. in some circumstances may have of reducing price competition among manufacturers; that is, of increasing their effective monopoly power. Bork's discussion of this issue surprisingly is limited to one type of effect alone, that of the use of r.p.m. as a means of policing a horizontal price agreement among manufacturers.[10] There is another type of effect which is analytically of more interest and empirically of more importance.

Price competition in retailing can be an independent source of instability in the individual market shares of a group of oligopolistic manufacturers. The additional instability may cause price competition among the manufacturers (in their sales to the trade) to be more frequent and intense than otherwise. Hence the manufacturers may independently—that is, without collusion—introduce r.p.m. in the interests

7. This type of situation is not referred to by Bork, who is, however, at pains to establish that "reseller pressure for a manufacturer-imposed restraint" cannot be effective "without actual reseller cartelization." Bork at 410 n.73.

8. For the same reason the members of an oligopoly group might introduce r.p.m. without collusion. As long as each oligopolist had the same long-run apprehensions, a follow-my-leader adoption of r.p.m. could occur. Collusion would naturally facilitate the process; and in practice it would be virtually impossible to detect. It certainly could not be inferred from a nearly simultaneous adoption of r.p.m., if only because the same phenomenon would be compatible with the adoption of r.p.m. as a weapon of competitive sales promotion.

9. For a discussion of a different way in which r.p.m. practised by a monopolist can serve to preserve a monopoly position, *see* MONOPOLIES COMMISSION, REPORT ON THE SUPPLY OF WALLPAPER (1964) (especially para. 159).

10. Bork at 411-15.

We agree with Bork's conclusion that r.p.m. is unlikely to be valuable as an aid in the policing of a manufacturers' cartel arrangement. However, the fact that its possible use in this capacity cannot be excluded entirely (Bork at 412) weakens Bork's favourable conclusion on r.p.m., because it would be difficult to distinguish this particular use of r.p.m. from other uses. See note 8 *supra*.

of reducing price competition *inter se*; the process by which this comes about may well be analagous to that of the emergence and exercise of non-collusive price leadership in oligopoly situations. The net result will be a smaller industry output, which is, nevertheless, more profitable to the manufacturers.[11]

The four counter-examples are sufficient to show that the universality claimed by Bork for his favourable conclusion is illusory: r.p.m. may be adopted rationally with the intent and effect of reducing output, that is, in Bork's terminology, of reducing efficiency; or it may have this effect without it being intended. Moreover, it is not unrealistic to claim empirical importance for the counter-examples.

II.

Professor Bork recognises that those who practice r.p.m. with the intent of increasing efficiency may in fact be mistaken so that the net effect is to reduce efficiency. He argues, however, that this consideration should not affect his general conclusion, and says that for "a court to strike down" r.p.m.—he takes vertical market division as his example, but applies his observations to r.p.m. as well—"on the theory that the manufacturer had made a mistake as to the most efficient mode of distribution would be equivalent to judicial supervision of any other normal business judgment,"[12] and should not be permitted. The argument, however, is weak.

Bork's discussion fails to recognise that r.p.m. in practice involves the "supervision" by the manufacturer of the "normal business judgment" of resellers. Resellers are not permitted to follow such price policies as they think fit, but have to toe the line prescribed by the manufacturer. Whatever else it may do, r.p.m. restricts the freedom of decision of resellers. If it is improper for a court to engage in "supervision" of a manufacturer's decisions, it is not obvious why a manufacturer should be allowed to engage in the supervision of the decisions of other business firms. Bork may reply that the resellers "agree" to this supervision and the supervision is accepted voluntarily. Indeed at one point he writes: ". . . The parties to each such agreement [including vertical price-fixing agreements] are motivated by a desire for increased efficiency. The parties, therefore, have already weighed any losses in efficiency due to the suppression of intrabrand competition and found

11. For fuller discussion *see* RESALE PRICE MAINTENANCE 9-12 (B. Yamey ed. 1966).
12. Bork at 404.

them more than balanced by gains in other efficiencies."[13] Elsewhere he refers to vertical price-fixing "agreements."[14] It is unrealistic to use such language in relation to r.p.m.; the notion that the "parties" indulge in such deliberations is particularly fanciful. Even if all the relevant resellers sign agreements with a price-fixing manufacturer, this does not constitute evidence that each reseller is motivated by a desire to improve efficiency, and that some resellers would not prefer freedom to determine their own resale prices and do not disagree with the manufacturer's assessment of the overall situation. Where the manufacturer is a monopolist, or where all or most competing brands are price-maintained, a reseller must "agree," whatever he might think of the restraint imposed upon him. Moreover, in many cases r.p.m. has proved to be ineffective in practice unless it is made enforceable by law against non-agreeing resellers. In short, a programme of r.p.m. in practice does not involve the voluntary agreement of all parties affected, but does involve the "supervision" and overriding by the manufacturer of the "normal business judgment" of others.

Further, r.p.m. restrains competition among resellers and, therefore prevents or delays changes in the distributive trades. It is, therefore, liable to cause inefficiency in practice even where it has been introduced to promote efficiency. Manufacturers introducing r.p.m. do not know the full and detailed long-term effects of their practice on the distributive trades. They, therefore, do not know when it would become desirable for them to give up the practice in their own interests or to modify the margins allowed to resellers.[15] (In practice, moreover, it may be difficult to give up the practice deliberately.) It is, therefore, likely that with the passage of time r.p.m., however well-conceived when initiated, comes to restrict output rather than to increase it.

It is important in the context that there is no automatic corrective in the market-place. Thus, where r.p.m. covers all or the major brands of a product or group of products, it prevents the discovery of information relevant to a decision whether or not it increases efficiency, and there is a reasonable possibility that in the course of time it will come to decrease efficiency by inhibiting change. (This is, of course, quite independent of the considerations discussed in Section I above.) The practice, where it affects the whole or a large part of the trade in ques-

13. *Id.* at 472.
14. *Id.* at 475.
15. In the third counter-example in Section I, *see* p. 725 *supra*, the assumed situation is different: the manufacturer anticipates in general terms what would happen without r.p.m., and is not primarily concerned with efficiency in distribution.

tion, serves to prevent or dilute the process of the competitive elimination of inefficient resellers and the competitive entry of innovating and more efficient new resellers. Bork's analysis fails to take account of these effects of r.p.m.—a neglect which would be defensible only where r.p.m. does not affect a large part of the trade in the product or group of products, or where the successful introduction of new brands, by resellers or others, is easy. (And in the latter type of situation, one would not expect to find much r.p.m.)

Thus there are grounds, apart from those set out in Section I, for rejecting Bork's conclusions that r.p.m. "will never be instituted with either the intent or the effect of restricting output"[16] and that r.p.m. is "incapable of restricting output."[17] It is shown that even where the *intent* is to increase output, it is not unlikely that the *effect* will be the opposite. Investigations have uncovered only the odd exceptional case where it can be documented that the removal of r.p.m. caused output of the goods to decrease rather than to increase. Manufacturers' predictions of serious reductions in sales invariably have proved to be false. Business men may well in general be the best judges of what is in their own interests. However, there is ample empirical evidence to show that where their decisions restrict competition among their customers, as in r.p.m., they generally have been wrong. This would not matter much if their errors provoked speedy correction and did not involve restraint of others. With r.p.m., neither condition is satisfied. This, it would seem, distinguishes this type of business error from other types of business error (such as Bork's examples, errors on "assembly line planning, inventory policy, [and] product design")[18] when viewed from the point of view of public policy towards monopoly and competition.

III.

Throughout this discussion Bork's test of the harmfulness of r.p.m. is whether it results in a smaller output. But Bork goes to some lengths to ground this test in the theory of welfare economics by showing that, while in perfect competition price equals marginal cost, in monopoly price exceeds marginal cost; and thus that welfare can be increased by transferring resources from competitive to monopolistic industries.[19]

16. Bork at 475 n.207.
17. *Id.* at 404-05.
18. *Id.* at 404.
19. *Id.* at 392-94. Bork quotes G. J. Stigler's warning that the objection to monopoly

What Bork did not make sufficiently clear was the restrictive nature of the assumptions underpinning this welfare proposition. It would be inappropriate to rehearse the necessary qualifications to this conclusion.[20] These are numerous and their discussion highly technical and somewhat esoteric. It is unrealistic to suppose that those entrusted with the formulation and implementation of monopoly policy would pay much regard to the pure theory of welfare economics, and it is not obviously desirable that they should be required to do so. The latter consideration applies also to an unqualified proposition such as Bork's that the welfare test is whether or not the practice or situation increases or reduces output.

Monopoly policy need not rest on the allocative considerations discussed in the somewhat rarefied air of welfare theory. In the more robust and rough-and-ready world of public policy other, simpler, matters are worthy of being taken into account. Again, it would be inappropriate to attempt here a full investigation of the possible considerations. We mention two points, neglected or inadequately treated by Bork, which seem particularly relevant in the context of r.p.m.

First, r.p.m. inhibits the freedom of resellers to experiment with new forms of retailing. We discussed this point above when showing that, although the manufacturer's intent might be to increase output, the long-run effect could be the reverse. Here we would stress its more general significance and suggest that interference with innovation and experiment is *prima facie* against public policy.

Second, r.p.m. restricts the range of consumers' choice. Bork, himself, seems to have some misgivings about the reduction in the range of alternatives open to consumers under r.p.m. "The preference of any significant number of consumers for lower price instead of sales effort or post-sale service" will "evoke a response from some producers."[21] But even if this were so, what of those consumers who prefer the brands which are price-maintained to all other brands, and also prefer lower prices to post-sales service? The restriction of the range of consumer choice is *prima facie* against public policy.

is not simply the restriction of output but that "productive service will have a less valuable marginal product in competitive than in monopolistic industries." Bork at 394 n.49. Nevertheless Bork continually writes as though the restriction of output is harmful. But if the reduction in output occurs because marginal costs are higher than they would be otherwise (as in our first counter-example) the divergence between price and marginal cost may well be smaller than otherwise. We do not mean to imply that welfare will therefore increase—rather that Bork did not sufficiently take to heart Stigler's injunction to consider marginal products.

20. For a systematic examination see Mishan, *A Survey of Welfare Economics, 1939-1959*, 70 The Economic Journal 197 (1960).

21. Bork at 473.

These two considerations alone are enough to set up a *presumption* that r.p.m. is against the interests of consumers. Moreover, even if we were to disregard these considerations and accept Professor Bork's welfare criterion, we have shown in Section I that his unqualified assertion —that r.p.m., in the absence of cartels, is bound to serve the interests of consumers—is unwarranted.